Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:MWD:OMA:TL-N-5793-98
DRKibler

date: DEC 03 1999

to: Chief, Examination Division, Midwest District
Attn: Team Coordinator Paul D. Taylor

from: Associate District Counsel, Midwest District, Omaha

subject: **Advisory Opinion - Capitalization of Bonuses**

This is in response to your request for an advisory opinion.

ISSUE

Whether the taxpayer may deduct bonuses which are attributable to the previous acquisition of a subsidiary and previous recruitment of key personnel to subsidiaries under I.R.C. § 162(a) and/or whether the expenditures must be capitalized under I.R.C. § 263(a) and INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).

CONCLUSIONS

Based upon the information currently available, an adjustment requiring capitalization of the expenditures is insupportable. Similarly, based upon the information currently available, an adjustment under section 162(a) is insupportable.

FACTS

The Internal Revenue Service is examining the [redacted] through [redacted] taxable years of [redacted] hereinafter, "[redacted]". [redacted] is a [redacted] company, and the parent company of several entities, one of which is [redacted], hereinafter "[redacted]", a holding company. Following the breakup of [redacted], [redacted] was hired frequently to install [redacted] and perform other necessary [redacted] work in the [redacted] industry. At that time, [redacted] was employed as an [redacted] by [redacted]. [redacted] suggested that [redacted] enter the [redacted] market as owners rather than merely as providers of [redacted] services related to the industry. In approximately [redacted], [redacted] formed a new subsidiary, [redacted], hereinafter, "[redacted]", as a provider of [redacted] services, such as local [redacted] services, [redacted] services and [redacted] services. At that time, [redacted] became the [redacted] of [redacted]. [redacted] was created through the acquisition[1] of existing [redacted] corporations combined with the creation of new [redacted] providers. In [redacted], [redacted] went public, with approximately [redacted] to [redacted] percent of its stock held publicly. [redacted] continued to own the remaining stock, but [redacted] was no longer part of the consolidated return filing of [redacted]. In [redacted], [redacted] acquired [redacted]% of the stock of [redacted]. Prior to the acquisition of the stock of [redacted] by [redacted], [redacted]'s stock in [redacted] was transferred to [redacted]'s stockholders, who then received [redacted] stock in exchange for the [redacted] stock. The [redacted] stockholders were greatly enriched by the stock exchange.

[redacted] accrued and deducted $[redacted] in bonuses during [redacted], with $[redacted] paid during [redacted] and the remaining $[redacted] accrued in [redacted] for payments made on [redacted]. In response to an Information Document Request, "IDR", seeking an "explanation, other documentation, and invoices which would explain" entries reflecting the accrued payroll expenses in [redacted]'s Detailed Trial Balance History for administrative salaries, the taxpayer responded, in part, by providing a copy of a [redacted] letter from [redacted] of [redacted] to the Chairman of the [redacted], hereinafter, "letter".

The letter reflects that on [redacted], the [redacted] of [redacted] approved, subject to the approval of the Compensation Committee, a bonus pool of $[redacted] for [redacted] and his management team for "their extraordinary achievements in creating value for the [redacted] shareholders". The letter reflected the achievements as including: 1) assistance in recruiting [redacted] to [redacted], [redacted] to [redacted] and [redacted] individuals from [redacted] to [redacted][2]; 2) working with each of the newly hired individuals in establishing their respective teams and advising them on various business matters; and 3) developing the [redacted] concept which is now being implemented by [redacted]. The letter further reflects that "[redacted]'s most significant achievement was in the creation of [redacted]

---

[1]The acquisitions were "friendly", except certain minority stockholders were successful through litigation in obtaining more money for their stock.

[2]We assume that the named individuals represent key personnel and that the entities represent subsidiaries of [redacted] or [redacted].

He was the driving force behind [redacted]'s investment in [redacted] and provided the leadership necessary to build the [redacted] and to organize a team of talented individuals to run it. Without [redacted]'s foresight, knowledge, and leadership this extremely valuable asset would never have been created".

LEGAL ANALYSIS

I.R.C. § 263(a)(1) provides, in pertinent part, that "[n]o deduction shall be allowed for [a]ny amount paid out for new buildings or for permanent improvements or betterment made to increase the value of any property or estate". The purpose of I.R.C. § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974).

In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), a unanimous Supreme Court held that professional fees (investment banking, legal, and other costs) incurred in a "reverse subsidiary cash merger" which resulted in long-term benefits were not deductible as ordinary and necessary business expenses under I.R.C. § 162(a), and must be capitalized under I.R.C. § 263. The Court clarified a conflict among the circuits that creation or enhancement of a separate and distinct additional asset is not a prerequisite to capitalization of expenses, and that Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345 (1971) did not change familiar backdrops nor announce an exclusive test for identifying capital expenditures.

The Court stated that a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization, citing, United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972) (stating expense that is of value in more than one taxable year is a nondeductible capital expenditure) and Central Texas Savings & Loan Assn. v. United States, 731 F.2d 1181 (5th Cir. 1984), (providing that while the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item.) In addition, the Court found support for its decision in the language of I.R.C. § 263(a)(1), "permanent improvements or betterment", which the Court stated envisioned an inquiry into the duration and extent of the benefits realized by the taxpayer. The factual findings which supported the finding of realization of benefits beyond the year were that National Starch obtained resourcerelated benefits (synergy with Unilever anticipated due to its strength in basic technology, the nature of their operations, and the strong consumer products orientation) as well as other benefits (administrative convenience and simplicity in the elimination of the 3500 shareholders for one).

Post-INDOPCO, the characterization of an expenditure as one incurred in the creation of a separate and distinct asset remains important due to the numerous United States Supreme Court decisions which point to that fact when finding that capitalization is required: Commissioner v. Idaho Power Co., 418 U.S. 1 (1974); United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972); Woodward v. Commissioner, 397 U.S. 572 (1970); Commissioner v. Lincoln Savings and Loan Assn., 403 U.S. 345 (1971); Helvering v. Winmill, 305 U.S. 79 (1938).

In Norwest Corp. & Subs. v. Commissioner, 112 T.C. 89 (1999), the Court held that the taxpayer, Davenport Bank & Trust Co. (DBTC), was required to capitalize investigatory costs, due diligence costs, and officer's salaries incurred in 1991 attributable to its acquisition by a bank holding company during 1992. The Court agreed with the Internal Revenue Service that INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) required capitalization because the costs were connected to an event (namely, the transaction) that produced a significant long-term benefit.

In Norwest, supra, the Court rejected the taxpayer's argument that the costs should be currently deductible because the costs were incurred before DBTC's management formally decided to enter into the transaction. The Court articulated the following in support of its rejection of the timing argument: 1) INDOPCO displaced the body of prior law set forth in Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973) and its progeny insofar as they allowed deductibility of investigatory costs in settings where an expenditure does not create a separate and distinct asset; and 2) previous rejection of this argument based upon the importance of a finding that expenditures made with the contemplation that they will result in the creation of a capital asset cannot be deducted as ordinary and necessary business expenses even though that expectation is subsequently frustrated or defeated.

I.R.C. § 263(a) is commonly considered in tandem with I.R.C. § 162 when considering whether an expense must be capitalized. Although even if an expense meets the requirements of I.R.C. § 162, I.R.C. § 263 takes precedence over I.R.C. § 162 by virtue of the "priority-ordering" terms of I.R.C. § 161. Cf., Commissioner v. Idaho Power Co., 418 U.S. 1 (1974).

To qualify for deduction under I.R.C. § 162(a), "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." INDOPCO, supra, citing Commissioner v. Lincoln Savings and Loan Assn., 403 U.S. 345 (1971).

A parent corporation may not deduct cash bonuses it pays to employees of its wholly-owned subsidiary for services rendered to the subsidiary as a business expense under I.R.C. § 162. However, because the parent's payments of cash bonuses is a constructive contribution to the subsidiary's capital accompanied by a constructive payment by the subsidiary of the cash bonuses to its employees, the cash bonuses may be deducted by the subsidiary under section 162. Rev. Rul. 84-68, 1984-1 C.B. 31.

Although the Commissioner may argue that the expenditures are not allowed under I.R.C. § 162(a) because [redacted] was an employee of [redacted], rather than [redacted] at the time of the payment of the bonus, based upon the facts currently known to the Examination Division, it appears possible that the taxpayer may be able to successfully argue that [redacted] provided services concurrently to each of the named entities. The taxpayer may be able to support that [redacted], in addition to his services to [redacted] as its Chief Executive Officer, also provided important services directly to [redacted] and [redacted] by his successful recruitment and initiation of key personnel to [redacted] subsidiaries. To support an adjustment under this theory, additional facts would need to be secured, such as requesting details as to the identities of the "management team", how the bonus pool was distributed, dates when the services were provided, the employment relationship (or other type of relationship) of [redacted] and the management team to [redacted].

Although the Service could argue that the portion of the bonus paid to [redacted] that is attributable to his services in creating [redacted] should be capitalized as a cost related to the creation of an asset, the timing of the bonus in relation to the creation of [redacted] will prove problematic. Norwest, supra, the first case to interpret INDOPCO, supra, where capitalization of wages was required, does not support capitalization of the bonuses in this case due to the timing difference. Currently, no analysis has been done to reflect whether the expenditures for bonuses represented a distortion of income based upon their relation to the current production of income from [redacted]. The

---

[3]We do not know which [redacted] entity employed the "management team".

taxpayer could argue that the purpose of section 263, that of preventing a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing, is inapplicable to bonus payments made eight years after the formation of the asset.

In summary, additional facts would have to be secured to potentially support an adjustment requiring capitalization of the bonuses. Based upon the current facts known to us, however, we find it unlikely that, even if additional facts were discovered, capitalization would be supportable due to the timing issue.

DISCLOSURE STATEMENT

Our opinion is limited to the information provided to us for review. This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve any Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Please call the undersigned at (402) 221-7333 if you should have any questions.

J. ANTHONY HOEFER
Acting Associate District Counsel

By: (signed) Deanna R. Kibler

DEANNA R. KIBLER
Senior Attorney